MOODY'S
INVESTORS SERVICE

New Issue: MOODY'S DOWNGRADES TO Aa2 FROM Aa1 SAN FRANCISCO'S G.O. BOND RATING; OUTLOOK REVISED TO STABLE

Global Credit Research - 17 Nov 2010

Ratings On Outstanding General Fund-Related Obligations Also Downgraded One Notch

Municipality
CA

Moody's Rating

ISSUE		RATING
General Obligation Bonds (Earthquake Safety & Emergency Response Bonds), Series 2010E		Aa2
Sale Amount	$80,000,000	
Expected Sale Date	12/01/10	
Rating Description	General Obligation Bond	

Opinion

NEW YORK, Nov 17, 2010 -- Moody's Investors Service has downgraded to Aa2 from Aa1 the rating on the City and County of San Francisco's General Obligation Bonds and assigned an Aa2 rating to the city's General Obligation Bonds (Earthquake Safety and Emergency Response Bonds, 2010) Series 2010. We have also downgraded by one notch our ratings on the city's various general fund obligations, including its abatement leases and settlement obligation bonds. The outlook on the city's ratings has been revised to stable.

RATING RATIONALE

The downgrade primarily reflects the city's very narrow financial position and the minimal prospect of material improvement in the near term. The city ended fiscal 2009 with a balance sheet that was weaker than at any time in the prior ten years and extremely weak by comparison with other similarly rated local governments. Its fiscal 2010 and 2011 budgets both relied heavily on one-time solutions, including draws on reserves, to close sizable projected budget gaps, suggesting that final audited results will show little balance sheet improvement. The lackluster economy cannot be expected to provide substantial relief in the near term. Recent reports from the state confirm that its fiscal challenges continue to loom large, which in turn injects revenue risk into the city's current and next year budgets. The defeat in the election earlier this month of a local pension and health care cost control measure suggests that little near-term fiscal improvement is likely to result from external political pressure. The election of the Mayor to Lieutenant Governor also created a potential leadership gap, which may or may not be filled expeditiously, at a time when the city faces very large budget gaps in fiscal 2012 and 2013. The city's demonstrated strong budgetary control is a critical, positive factor captured in the current rating. The city's ratings continue to reflect its position as a large, world renowned city with a diverse economy and strong resident wealth levels. Its moderate debt burden, which is conservatively structured, is also incorporated into the ratings.

The current financing is secured by an unlimited property tax pledge: the city has the power and obligation to levy property taxes in an amount sufficient for payment of principal and interest on the bonds when due. The two series currently being issued comprise the first under a $412.3 million authorization approved in June 2010 by at least the required two-thirds of voters. As required by the authorization, bond proceeds will be used to fund improvements relating to earthquake preparedness and response.

CITY'S NARROW BALANCE SHEET UNLIKELY TO BE RESTORED TO PRIOR LEVELS IN THE NEAR TERM

The city's audited general fund reserve position is extraordinarily thin, with the GAAP-based fiscal year (FY) 2009 unreserved fund balance of $28.2 million representing just 1% of general fund revenues. This is low even for the city, whose narrowest unreserved fund balance in the previous ten years had represented 2.0% of revenues ($35.7 million, FY99). Further, the decline has been fairly precipitous: as recently as FY05 unreserved fund balances represented 5.7% of revenues or $134.2 million; while it declined as a percentage of revenues, the absolute level of unreserved fund balance reached a high of $141.0 million in fiscal 2007. The city's inability to stem the decline and likely difficulty in rebuilding its reserve levels is a key contributor to the rating downgrade.

Also contributing to the rating downgrade is the fact that the city's substantial structural imbalance is not likely to be corrected in the near term. The city's FY10 budget was closed with 40% "one-time" budget balancing measures, and its $3.0 billion fiscal 2011 budget used 53% of one-time measures to address a $483 million deficit. Both years relied in part on fund balance draws. In the current fiscal year, the city is showing modest, first quarter budget improvement in comparison with the adopted budget. However, this does not appear sufficiently substantial to put the city on a sound financial footing. The economy in the city is lackluster at the moment, and unlikely to enhance the city's revenues at a rate that will help restore the city's reserves in the near term. While the city's long-term economic prospects remain sound, Moody's Economy.com indicates that the city's recovery currently is slowing as a result of the slow national economic growth and weakness in the city's business services sector, particularly financial services.

The city's three-year budget projection in April showed a $712 million budget gap for FY12 and a $787 million gap for FY13 assuming no changes were made to baseline revenues and expenditures. With the ongoing measures adopted subsequent to that projection, the FY12 gap was cut to $394 million (no updated estimates are available for FY13). The improvement is substantial but there are no indications that there is the political will or practical ability to bridge this still very large gap in a structurally sound manner. In fact, in the recent election voters defeated Proposition B which would have required city employees to contribute more towards their pension and health care benefits. While the city did not count on these revenues for the current year budget, it appears clear that there is no political pressure to cut programs and services in order to achieve structural balance. Voters also defeated Proposition K which would have resulted in $6 million additional hotel tax revenues in the current year. These were the only revenues generated by the current year's propositions that were assumed in the FY 2011 budget, so their loss will need to be addressed. Voters also defeated an increase in the hotel tax, Proposition J, which would have generated an estimated $38 million in additional

revenues annually. Voters did approve Proposition N which increased the real property transfer tax on very high-end properties, providing a fairly volatile and unpredictable revenue stream. The state's adopted budget took $7 million of funding from the city in fiscal 2011, well within the $30 million budgeted against that eventuality. However a substantial risk remains as the city, like all local governments that receive state funds, is not safe from mid-year and subsequent-year funding reductions, particularly given the state's recently re-affirmed financial challenge in the current and coming fiscal year. Given the city's narrow fund balances, substantial state cuts could have a severe impact on the city's financial strength.

The city's strong budget controls and careful revenue projections are an important credit positive, mitigating to a certain extent the city's historically thin reserves. In fact the current year budget is showing some improvement over initial assumptions. The FY10 budget-year ended above previous assumptions by $25.4 million, an amount almost entirely preserved in fiscal 2011, despite some substantially negative line items and even after a return of $12.3 million to the city's Rainy Day Reserve Fund as required by statute. The Rainy Day Reserve Fund is now projected to end fiscal 2011 with a balance of $33.4 million, a substantial improvement over the $6.2 million in the Mayor's original proposed budget, though still very modest in comparison to the county's nearly $3 billion total general fund revenue.

Over the longer term the city's Board-adopted reserve policies will help it rebuild its reserves when the economy resumes strong, sustained growth. At the controller's suggestion, the Board expanded its reserve policy to include a new "General Reserve" and "Budget Stabilization Reserve" to supplement the existing "Rainy Day Reserve." Rules for building up and drawing down these reserves are built into the policies. While these policies are positive long-term credit factors, they do not require particularly strong base level reserves, nor do they mandate restoration of balances with any rapidity.

San Francisco's pension system is relatively well funded, but like most municipalities the city's increasing, required contributions will likely pose a fiscal challenge so long as revenue growth remains constrained by the weak economy. Also, San Francisco's other post-employment benefit (OPEB) liability is extremely large and will be a significant long-term challenge. The most recent actuarial valuation puts the city's unfunded liability at $2.6-to-$4.0 billion (depending on funding assumptions). Funding the city's retiree health care benefit at a full, actuarially required amount would require the dedication of an additional 5%-to-10% of the city's general fund revenues. City voters approved a charter amendment that reduces the post-retirement eligibility and benefits available to new hires starting in January 2009. But virtually no progress has been made in addressing the already outstanding liability. While this is a long-term challenge, rather than one that is pressing, many municipalities, particularly those that are highly rated, have made substantive progress in addressing their OPEB liabilities. Our Aa2 rating on the city's G.O. bonds assumes that the city will prepare a long-term solution to this funding challenge which it will implement when economic conditions improve.

TRANSITION PROCESS RESULTS IN SOME UNCERTAINTY FOR COMING YEAR

Earlier this month the city's mayor was elected to lieutenant governor, suggesting some potential managerial and political uncertainty over the coming year due to the somewhat open-ended process for appointing a replacement. The city charter specifies that immediately upon the mayor's resignation, the President of the Board of Supervisors automatically becomes Acting Mayor. The Acting Mayor has full mayoral power, and can continue in this post until the next scheduled mayoral election in November 2011. However, the Board of Supervisors also has the option at any time to appoint a successor Mayor. Neither the city charter nor the municipal code specifies a process for the Board to use in selecting the successor. There is also no timeline by which the Board needs to act, so it could start (and stop) the process as and when it deems appropriate. This situation clearly poses a risk that both the Acting Mayor and the Supervisors could be distracted from the business of effectively managing the city's ongoing operations and its financial health. While political transitions are rarely a significant credit consideration, this is a notable, short-term credit negative given the city's already narrow financial position, the weak economy, and the state's precarious budget.

MODERATE DEBT LEVELS CONSERVATIVELY STRUCTURED; MINIMAL VARIABLE RATE DEBT

The city's direct and overall debt burdens stood at 1.4% and 2.0% as of fiscal year end 2009, and are expected to increase to still moderate rates as of the end of the current fiscal year. As of June 30, 2009 the city had $1.2 billion of authorized unissued G.O. debt. The city has stated its intention to maintain its existing G.O. bond property tax rate, and it has planned to issue new debt in line with assessed valuation growth. Given the sound rise in AV this year, debt burden should remain moderate. The city is limited by charter to issuing G.O. debt totaling no more than 3% of secured assessed value.

The structure of San Francisco's outstanding GO debt is conservative. The city typically uses a level debt service structure and twenty to twenty-five year final maturities, rather than thirty years, and the structure of the current issue is expected to be consistent with this practice. The city's resulting ten-year rate of direct, tax-supported debt retirement is a favorable 64.8%, and total debt service declines annually. A relative weakness in the city's debt profile is indicated by its high direct and overall debt per capita figures of $2,411 and $3,434. Given the wealth of city residents, however, this is not a material credit concern.

The city's exposure to the variable rate market is quite modest. None of the city's general obligation debt and only one of its outstanding lease-backed obligations is variable rate. The city recently initiated a commercial paper program which Moody's believes is also manageable and conservatively designed. The city's general fund cash and investments as reported in its fiscal 2009 audit is more than twice the city's variable rate exposure, suggesting that the general fund can absorb the impact of any failed remarketing. This is important given that the Treasurer has expressed a reluctance to purchase the city's variable rate or commercial paper obligations as investments for its pool, citing appearance of conflict of interest.

The variable rate lease is a $141.6 million convention center lease representing about 14.3% of the city's $992.8 million of outstanding lease-backed debt and just 6.7% of its $2.16 billion of total direct debt as of fiscal year end 2009; by the end of the current fiscal year the long-term variable rate debt is expected to decrease as a percentage of the total given that the amount of the city's outstanding lease obligations has risen. Lease payments for the variable rate financing are made from a dedicated hotel tax established by city voters for the express purpose of funding the related capital improvements. The hotel tax provides ample debt service coverage and excess revenues are deposited in a special revenue fund rather than the city's general fund.

The commercial paper program was authorized at $150 million in March, 2010. The city has only obtained letters of credit to support $100 million, suggesting that is the maximum amount expected to be issued in the near term. The program is intended to provide interim funding during project acquisition or construction, with long-term take-out financing once the project is completed and costs are known. According to the staff memo provided to the Board when it authorized the program, projects can only be funded with the commercial paper program if the long-term permanent financing has been approved as well, a positive credit factor.

ASSESSED VALUATION GROWTH PARTIALLY REFLECTS EARLIER YEARS' ACTIVITY

San Francisco is both a city and a county. Its sizable assessed value (AV) approximates the median for large, highly rated cities nationwide, and is well above the median for California counties. The city's AV has grown steadily each year for the past ten years, notably including the current year. For fiscal 2011 AV reached a total $163.4 billion after 3.7% growth over the fiscal 2010 figure. Based on state Board of Equalization data (which is formatted slightly differently than that presented by the city) San Francisco was one of only a handful of counties to show any AV growth at all this year, compared to a county median decrease of 2.1%. The city's fiscal 2011 AV growth resulted not just from fiscal 2010 real estate transactions, but also from prior years' transactions newly reflected on the tax rolls. AV is a lagging indicator, particularly in the city as the assessor works through backlogged transactions. Once the impacts of the residential real estate downturn and the recession are more completely reflected in the tax rolls, weaker AV growth or even modest decline is possible. Large decreases, however, are not anticipated. Home prices in the city were well above AV levels and price declines were smaller than they were elsewhere, so downward pressure on AV is likely to be limited. Pressure on AV growth may be driven by commercial property, particularly downtown office buildings. However office buildings represent only about 15% of the city's total assessed valuation so even dramatic declines for individual commercial office properties would not likely have significant overall AV implications.

As one would expect from a large, world renowned city, San Francisco's tax base is diverse and tourist oriented: the ten largest property owners account for just 3.6% of assessed value, and represent primarily office, retail and hotel properties. San Francisco residents' socioeconomic profile is quite strong for a large U.S. city with per capita income at 152.2% of the state average and median family income at 119.8% of the state average. San Francisco's median family income also appears to have improved in recent years: as of the U.S. Census Bureau's 2006-2008 American Community Survey 3-Year Estimates, San Francisco's median family income rose somewhat to between 122% and 130% of the state average (the range reflects the survey's statistical margin of error). Unemployment in the city stood at 9.6% as of June 2010, in line with the national rate and well below the state's 12.2%. Moody's continues to believe that the city's economy is fundamentally sound, with its diversity and its highly skilled labor force supporting long-term growth.

Outlook

Our outlook for the city's long-term ratings is stable. The current rating incorporates the city's weak financial position with few prospects for substantial fund balance growth in the near or medium term, mitigated by strong budgetary controls. The city's fundamentally sound economy, despite current weakness, and strong socioeconomic profile are important, stable credit factors as is its generally conservative debt profile.

KEY INDICATORS

Fiscal 2009:

Net General Fund cash, % of revenue: 9.3%

Total General Fund balance, % of revenue: 10.6%

Unreserved General Fund balance, % of revenue: 1.0%

Net direct debt, % of AV: 1.4%

Overall net debt, % of AV: 2.0%

Peak lease payment, % of General Fund revenues: 4.0%

2000 Census:

Median Family Income: $63,545 (120% of the state average)

Per Capita Income: $34,556 (152% of the state average)

Persons below poverty: 11.3%

The last rating action with respect to the City and County of San Francisco was on September 16, 2010 when a rating of Aa2 was assigned to the city's Refunding Certificates of Participation, Series 2010A

The principal methodology used in this rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009.

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